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SUBJECT: UPPER HOUSE ELECTION COMPLICATES ECONOMIC
POLICYMAKING

Summary

1. (C) The stunning defeat Japanese voters handed the ruling Liberal Democratic Party (LDP) on July 29 stems primarily from domestic concerns the Diet will have to tackle when it reconvenes in the autumn. The Democratic Party of Japan (DPJ) takeover of the Upper House complicates the LDP's ability to resolve issues like pension reform, tax reform, agriculture reform, and various economic trade agreements expediently and without compromise. Following is an outline of Embassy expectations for these issues, a brief discussion of the future of the Council for Economic and Fiscal Policy (CEFP), reactions of investors and key business leaders, and an explanation of the mechanics for passing legislation. End Summary.

Pension Reform Gets Messy

2. (C) Putting aside the issue of finding owners for 64 million unclaimed pension fund accounts -- the most important issue in the election according to all exit polls -- the LDP and the DPJ remain far apart on how to reform Japan's pension system, which consists of three parallel structures, each with a different premium structure, client base and financial capacity. The ruling coalition had planned to combine part of the company employees' pension plan and part of the government employees' mutual aid pension plan beginning in 2010. The DPJ on the other hand has proposed unifying all three programs, including the national pension plan into which the self-employed contribute. One problem this approach poses is that self-employed contributors often lack the income transparency that is common among salaried workers. In addition, many of these self-employed workers form the LDP's power base and they likely would oppose such a system.

Fate of Consumption Tax Increase Uncertain

3. (C) The Ministry of Finance had hoped to introduce a

consumption tax hike in 2009 but this could be delayed due to strong DPJ opposition. The DPJ has said it wants the consumption tax to remain at its current level. Government tax panel head Yutaka Kosai, with the support of Finance Minister Koji Omi, announced on July 31 that a debate on the tax would begin in the autumn as scheduled but he admitted that DPJ views would have to be considered. Chief Cabinet Secretary Yasuhisa Shiozaki commented in the press on July 30

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that the change in Upper House control meant the ruling and opposition parties would have to work together on how to proceed on the issue. Ministry of Finance Vice Minister Hiroki Tsuda announced on July 30 that "fundamental tax reform" discussions will be carried out in the autumn, which likely will include discussions about a consumption tax hike, a possible lowering of the corporate tax rate, and a review of taxes on financial income. This threatens the tacit understanding between the government and the ruling parties that the consumption tax would be raised to offset the planned increase in the state contribution to the pension system from the current one-third to one-half in fiscal 2009.

The business community also had hoped for a decrease in effective corporate tax rates following an increase in the consumption tax, but an increase in the consumption tax without pension system reform could further anger the voting public.

Doha, FTAs and Agriculture

14. (C) The LDP's election loss likely will delay any movement Japan has shown toward a more open trade regime and slow even further -- if that is possible -- agricultural reform. One issue raised in the press is the possible slowdown of the

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consolidation of farmlands because the DPJ has introduced new plans for compensating small farms for lost farming income. The ruling coalition had crafted policies that focus on larger-scale farms in an effort to encourage greater consolidation. Ministry of Agriculture, Forestry and Fisheries officials, who are suspicious of farm sector reforms, have said they may need to implement "DPJ policies that protect small farms" -- in effect seizing on the DPJ's opportunistic farm sector approach as a reason to delay reform. Such an approach on agriculture will make it more difficult for Japan eventually to do the right thing -- should the opportunity arise -- on a multilateral Doha Round trade deal. Moreover, ongoing FTA discussions with Australia as well as possible future discussions with the United States and the European Union are also under threat. Certainly the United States and Australia, as potentially significant FTA partners, have made it clear that all sectors, including agriculture, would have to be on the table.

CEFP and Public Works Spending

15. (C) The Council on Economic and Fiscal Policy (CEFP) under the Koizumi administration played an important role as policy advisor by setting government budget guidelines used to formulate the budget, but its influence has declined under the Abe administration due to a lack of leadership. Economic and Fiscal Policy Minister and CEFP head Hiroko Ota, a non-politician, recognizes that Japan must boost economic growth and promote fiscal consolidation in order to meet the challenges of globalization and Japan's rapidly aging society, but she lacks the leadership and Diet support necessary to further these goals. In addition, the Prime Minister himself has not uniformly backed the priorities of the CEFP, resulting in a lack of direction on economic policy from the top. A key test of the ability of the CEFP to move forward with its plans is the status of public works spending

in the next fiscal budget. It was expected that the government would cut public works expenditures by about three percent in line with its commitment to reduce expenditures by a maximum of 14.3 trillion yen over five years, but after major LDP losses in the rural regions, the ruling coalition may be forced to adopt a more cautious approach. The CEFP also could tackle such issues as the minimum wage to address growing economic disparity and convince the public it is serious about the downside of reform.

Business Groups Maintain Support for LDP

¶6. (SBU) Leaders of Japan's major business organizations -- Japan Business Federation (Nippon Keidanren) Chairman Fujio Mitarai, Association of Corporate Executives (Keizai Doyukai) Representative Director Masamitsu Sakurai, and Japan Chamber of Commerce and Industry leader Nobuo Yamaguchi -- have all indicated continued support for Abe and his reform policies. Mitarai also has expressed a desire to deepen talks with the opposition DPJ, however, and reportedly is seeking a balance between the DPJ and the ruling coalition. Mitarai and Yamaguchi have called for new party executives and a cabinet reshuffle. All three agree that economic concerns, including the pension problem, led to the LDP defeat. Keidanren was notably absent from the campaigning leading up to the election, unlike during the 2005 race when senior Keidanren officials under former Chairman Hiroshi Okuda actively supported the ruling coalition.

Investor Reaction Muted

¶7. (SBU) Investor reaction to the political turmoil has been muted probably because the outcome was largely expected and already reflected in market prices. The Tokyo stock market initially fell sharply the day after the election before recovering later in the day, but this related mostly to

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developments the previous Friday in New York markets. Some market analysts have suggested that if Abe's new cabinet is less reform-minded than the current one it could have an impact on the Bank of Japan's (BOJ's) expected decision to raise interest rates in August, although most agree that the political situation is unlikely to affect the outcome of the BOJ monetary policy board meeting later this month. The BOJ has already indicated in the press that it would study the current situation further before deciding on raising rates.

Turning Legislation into Law

¶8. (SBU) The Upper House and Lower House each have the ability to introduce new bills in the Diet, but to become law the bills must be approved by both chambers. If legislation is produced by the Lower House, for example, the Upper House can either put the bill to a vote or ignore it. If the Upper House ignores the bill for 60 days, the lower chamber then can either over-ride this with a second two-thirds majority vote or it can convene a joint committee of both chambers to look for a compromise. If a compromise is produced, the new bill must be approved in the Lower House before going to the Upper House. If the committee fails to agree, then the legislation dies. (Note: The Lower House has never in practice overridden the Upper House. Currently, out of a total of 480 Lower House members 306 belong to the LDP and 31 to Komeito giving the ruling coalition 337 votes. The opposition DPJ has 113 seats and the remaining 30 seats are divided among smaller opposition parties. A two-thirds majority is 320.)

Comment

19. (C) The government has told us its first priority in the upcoming Diet session will be to extend the Anti-terrorism Special Measures Law. Once that is done, we expect economic issues will be key points of contention. The election setback may force Prime Minister Shinzo Abe's government to abandon economic growth policies and heed opposition demands for a more equitable distribution of income. The DPJ has been handed an historic opportunity to work cooperatively and constructively on issues such as reforming the pension system and raising the consumption tax but it may choose to obstruct legislation instead. With the lower chamber in the hands of the LDP and the upper chamber in the hands of the DPJ, Japan at last will experience something akin to a two-party system and all the demands for compromise this entails. Whether the two parties are up for the task remains to be seen.
SCHIEFFER